

## INTRODUCTION

The use of the Protected Cell Company (PCC) concept is one of the most significant developments in the world of corporate finance for many years. This flexible new technology is already being used to provide a platform for a broad range of financial transactions, including the provision of a stable and cost-effective platform for securitisations and other transformer activities as well as a diverse range of more conventional insurance and other financial applications.

The purpose of this paper is to explore the developing usage of PCCs, the introduction of ICCs (Incorporated Cell Companies) and to anticipate opportunities and developments in the next few years. There have been a number of substantial developments in this market in the last few years, notably the incorporation of PCC regulations in Bermuda, Barbados, Gibraltar, Malta, Isle of Man and in many states in the USA and the associated widespread acceptance of PCC structures for applications which were previously merely predicted. Originally the use of cellular rent-a-captive structures began in Bermuda in the 1970s but it was not until 1997 that Guernsey created a new kind of captive that 'ring-fenced' the assets of the participating cells and allowed them to operate as distinct insurance entities.

The insurance market was in a state of turmoil following the World Trade Centre loss of 11 September 2001. Seeking equilibrium, following years of poor underwriting performance and recent downturns in investment returns, the market was hit by the largest insured loss in history. Some coverages remained tightened, capacity reduced, prices increased – a climate which is traditionally positive for captive insurers and PCCs undoubtedly benefited by being able to offer a formalised self-insurance option without the need to commit large amounts of ever-scarcer capital resources. The credit squeeze which is now impacting the financial markets may well create similar circumstances to which cell structures may well be able to respond to.

Within the world of insurance, it has been erroneously assumed that the main use for PCC technology is to enable the reinvention of the Rent-a-Captive. Indeed, many large insurers and intermediaries have quickly moved to establish PCCs for this very purpose, with varying degrees of success. This is just one of many current PCC uses and it would be quite wrong to equate "PCC" with "Rent-a-Captive", as so many of the more narrowly focussed specialist insurance press features have thus far pretended.

## PCC PRINCIPLES AND KEY FEATURES

Specific regulations have been introduced to provide statutory segregation of the assets and liabilities of individual users and co-owners using a corporate structure known generally as a Protected Cell Company. Application is across the world of banking and insurance, and it is fair to say that the PCC technology is a key catalyst in the fusion of those historically distinct financial markets.

The key features of a PCC are as follows:

- A PCC operates in two parts, with a non-cellular part (also commonly known as the core) and an unlimited number of cells, as shown in figure 1. There are many possible structures and the eventual structure adopted is tailored to the needs of the sponsor and users in each case; the following describes a typical arrangement. A new cell owner is met with minimum establishment costs and administration. The core capital can be a large amount, enabling full insurance risk transfer to be incorporated within the company's contracts, or alternatively can be a nominal amount, in cases where individual members provide cellular capital.

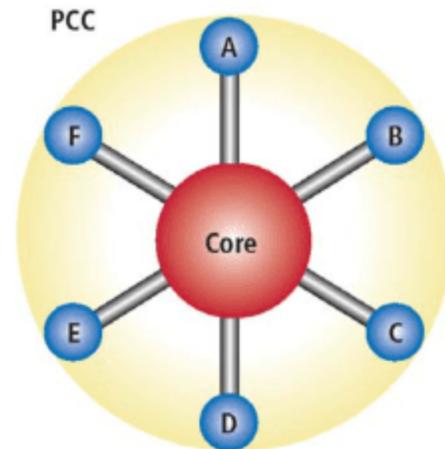


Figure 1

- Creditors of a PCC cell only have access to cellular assets of that particular cell plus the company's non-cellular assets (though, under certain circumstances, access may be able to be limited to cellular assets only). Should the assets be insufficient to discharge the cell-owner's liabilities, creditors then have recourse to the non-cellular assets, which are the responsibility of the PCC sponsor? In most cases, the cell owners are expected to collateralise any underwriting risk within their cell.
- PCCs can either be newly incorporated or, alternatively, an existing company can be converted to a PCC. The conversion option has proved to be relatively straightforward, and is clearly an attractive option where there is already an established company in the chosen location.
- A PCC is a single legal entity. It follows from this that the core of a PCC and its cells are not separate entities. Therefore a PCC has, and can only have, one board of directors, who manage the affairs of the PCC as a whole. Equally it will hold a single annual general meeting of its shareholders. However, a committee can be formed to oversee the operations of a cell under a delegated authority of the board.
- From a regulatory perspective, a PCC files a single annual return but regulatory approval is required in relation to the business plan of each cell.
- The PCC's tax status in the domicile in which it is located.

## FORMATION AND FUNCTION OF A CELL

The PCC's articles will normally empower the directors of the company to create cells at their discretion.

The provisions as to how cells are created are contained within the PCC's memorandum and articles. The process of forming a cell should be relatively straight forward, with the directors simply resolving to create a new cell. Any cell that it is to become active will require corporate registration and regulatory approval, in relation to:

- Cell shares that may be created and issued
- Licensing by the regulator for its planned activities

Each prospective cell owner is required to enter into a cell management agreement with the PCC board and will be bound by the memorandum and articles of association of the PCC. There will also be an agreement for management services with the manager of the PCC, which may be included within a tri-partite cell management agreement or dealt with by a separate agreement. The agreement(s) will be tailored to the specific requirements of the individual cell owners to reflect the type and nature of business they intend to transact and will confirm key issues such as entry and exit requirements.

Entry to the PCC is at the discretion of the PCC Board who will require details of the proposed business plan and will agree the parameters within which the cell is to operate.

In the case of an insurance cell, the risk gap (the difference between the premium and risk exposure) will need to be established and how it is to be funded. The risk gap may be reduced by the purchase of reinsurance and is normally covered by capital or capital "equivalents" such as partly paid callable shares, letters of credit or guarantees.

In some cases, a cell may operate with a risk gap that is not funded by the cell owner but is covered by the core assets of the PCC, under agreement with the PCC board. A premium will be charged for this and security arrangements will generally be required to cover the exposure of core capital.

Fees will typically be charged in relation to accessing the PCC, the PCC's administrative overheads and the administration of the cell and business conducted. This would be in addition to any charge relating to the exposure of core capital.

## USE OF PCCS

As already indicated, the PCC concept is not merely the reinvention of a rent-a-captive facility. The PCC concept is just as suitable as a means of commoditising Special Purpose Vehicles (SPVs) and as a basis of structuring investment products. The extension of PCC usage beyond traditional rent-a-captives and investment funds has been a major development.

The ownership of PCCs by banks and by insurers to transform banking products into insurance products and vice versa has been a big development, as it has actively encouraged the fusion of the worlds of banking and insurance. Vehicles owned by Lehman Brothers, Goldman Sachs and CSFB in Bermuda have demonstrated the potential, as has the creation of a number of vehicles owned by such financial institutions as Royal Bank of Scotland and Close Brothers in Guernsey. PCCs owned by banks and insurers have therefore been formed to be used as Special Purpose Vehicles (SPVs) for securitization transactions. In such transactions, the PCC may issue bonds, notes or other debt securities where the repayment is to be funded from the proceeds of the PCC's investments.

Aside from these unique structures, the primary classifications of PCCs are as follows:

Rent-a-Captive	The PCC owner offers traditional rent-a-captive services to clients with the added security of statute to support the segregation of assets and liabilities between cells. Insurance companies have been setting up PCCs to 'lock-in' policyholders who increasingly wish to be captive participants. This concept has been used very effectively in Continental Europe, where captive usage is relatively low. Large insurers have promoted the concept of "captive account facilities" for some years and have largely been able to avoid their clients forming their own captive operations. This model is now being adopted in other developed markets.
Insurance Companies	A number of insurance companies are using their PCCs not simply as a means of providing rent-a-captive facilities to their own client base but also to extend that facility to clients of other insurers who have no such facility. An important development has seen the use of PCCs by insurers as an alternative to a standalone captive for their own reinsurance retentions, using a separate cell for their own activities alongside the cells of client companies. This usage will doubtless increase in the future (see also Global Programme Solutions below, where this concept is explained more fully).
Associations	Association Captives have operated successfully for very many years, providing insurance coverage to members of trade associations or companies trading in a particular industry. Too often however, the idea of an association captive is too difficult to "sell" to the potential participants because of a disinclination to share risk – or even to share information – between individuals or companies who operate in direct competition with each other. The PCC concept is ideal as it permits segregation of assets and liabilities as well as enabling confidentiality to be observed. There has been little evidence of this type of PCC so far, but a difficult insurance market could precipitate some activity.
Offshore Life Insurers	Offshore life insurers have embraced the concept of PCCs to provide added protection to policyholders. Using separate cells for individual policies or products does not greatly increase running costs but ensures segregation of risk (and supporting asset classes). Should the life insurer decide to also write general business and become a composite, the PCC structure is one of the few accepted corporate structures to accommodate this without having to establish a separate general insurer (with associated costs of capital and marginal costs).
Niche Products	PCCs can be used to commute captive programmes, provide access to reinsurance markets including Terrorism pools such as Pool Re, write 'niche' products where conventional cover is unavailable or expensive and act as a reinsurer for customer services e.g. extended warranty. This is an indication that a PCC can provide a suitable structure for the development of revenue enhancement opportunities.

## GLOBAL PROGRAMME SOLUTIONS

Protected Cell Companies are also used to restructure global insurance programmes through a captive-type operation. The same structure can be used by insurers seeking to manage their underlying retentions around their reinsurance programme, also as an alternative to a conventional captive. The following benefits are identified:

- Ability to segregate risk by Group subsidiary or operating company.
- Captive capital can be provided by subsidiaries rather than wholly by Group.
- Segregated risk information can be used to identify risk management needs.
- Individual subsidiary underwriting can be carried out for low-level and primary layer losses.
- Profit recognition on a subsidiary basis can be achieved as individual cell results are readily identifiable.
- In the event of Merger and Acquisition (M&A) activity, a PCC-structured captive is far better suited to the identification, inclusion or removal of individual trading companies or subsidiaries.
- The interests of minority shareholders in Group subsidiaries and associate companies are safeguarded.
- Insurance cover for Joint-Ventures and strategic alliances can be provided through the captive on a fully segregated basis.
- The provision of high-level catastrophe coverage can be included on a cross-cell basis.
- In some locations, the PCC may be used to provide other offshore financial services, such as treasury, financing activities and inter-group invoicing.

## SPECIAL PURPOSE VEHICLES/TRANSFORMERS AND SECURITISATION

The PCC structure can also be used as a platform for any type of Special Purpose Vehicle (SPV), including those established as transformer vehicles to support securitisations. Even before the introduction of specific PCC legislation in Bermuda, entities such as Lehman Bros and Goldman Sachs established PCCs by making use of Bermuda's private law facility.

The use of an offshore SPV is already well understood and documented. It takes advantage of the same regulatory, legislative and fiscal environment which has benefited traditional captive business. Bermuda has a particular advantage, as the regulatory definition of "insurance" states that it is a contract that pays in the event of a loss of money or money's worth or that pays for loss occasioned on the happening of an event. The more forward-thinking of Guernsey's PCCs are now following the Bermuda lead in this area.

Structuring an SPV as a PCC also has the advantage of enabling the segregation of different classes or categories of investor. For example, particularly risk-averse investors may wish only for the coupon to be exposed with their capital commitment remaining intact, whereas others may be happy to risk both coupon and capital, in exchange for a higher potential return. This therefore increases both the flexibility and workability of the programme. The proof of true legal segregation of cellular assets is even more important in the area of SPVs than for the more traditional Rent-a-Captive vehicles.

There has been immediate success for those institutions that have established PCCs to provide a transformer capability for the provision of segregated SPV facilities. The main benefit is concentrating expertise and experience, whilst minimising the transactional costs involved in the separate licensing, operation and control of each programme. The reduction in marginal cost is likely to give such institutions a competitive edge.

## ROLE OF PCCS POST WORLD TRADE CENTRE

The state of uncertainty in insurance and reinsurance markets as well as the associated hardening in market terms in certain covers led to increased self-insurance for most corporations. Traditionally, this is a climate where captive business thrives as there was a need for all organisations to be able to demonstrate a clear risk management strategy and the formalisation of their risk financing programme through a captive – or PCC – vehicle was a logical step along a well-trodden path. At the same time, as insurance terms were hardening, the global economy was slowing, leading to reduced profitability for many organisations. This is a climate where increased self-insurance can provide more control and reduce the cost of risk.

PCCs will become ever more active in providing "virtual captive" services, especially where organisations do not wish to form their own captive vehicle, or are unwilling to commit capital funds. PCC products include:

- Financing of increased self-insured retentions with the development of flexible multi-year programs to smooth the occasional adverse experience at Group P&L level.
- Provision of coverage excluded by the conventional market (a form of "Difference in Conditions" protection).

Use of a PCC to manage retained risk does not create additional market capacity in the short-term but, as the market softens as it has done so recently, with the provision of additional capital from new and existing providers, it is possible to reinsure PCC retentions into this changing market environment. This is far simpler and more successful than trying to insure out of an internal fund as the financial and regulatory disciplines imposed by PCCs are attractive to potential risk bearers.

## CURRENT DOMICILE INVOLVEMENT

PCC legislation was pioneered by Guernsey in 1997, with the Cayman Islands introducing similar provisions soon afterwards. Even before Bermuda introduced dedicated legislation, over 100 PCCs were established under private law. PCC provisions have also been enacted in Vermont and the NAIC has introduced a model act specifically to encourage securitisation business back onshore. Barbados, Gibraltar and Malta have introduced PCC regulations. The Isle of Man followed in 2004. Of the established captive domiciles, only Luxembourg and Dublin have no confirmed plans to implement PCC regulations in the foreseeable future. This is less than critical to the use of PCCs, given that Gibraltar and Malta able to offer the facility throughout the European Union through EU "passporting" provisions.

This latter feature is likely to become increasingly popular especially as it will be particularly useful in structuring corporate programmes whilst producing an economical alternative to traditional fronting. It is also possible that combined solutions can be created for companies wishing to maintain captives outside the EEA (European Economic Area) whilst benefiting from the direct capability of a vehicle within the EEA. A captive can reside in an offshore location from where it reinsures a cell in a PCC in either Malta or Gibraltar, which effectively provides the offshore captive with direct writing capabilities into the 28 EEA countries at the lowest possible cost of capital.

## LEGAL ENFORCEABILITY

Initially, a number of commentators expressed doubts as to the legal enforceability of the PCC structure but the identity of the PCC sponsors in Guernsey and Bermuda demonstrates that some of the largest insurance companies and banks are confident enough of the legislation to have invested considerable resources. The addition of Vermont to the list of locations that have adopted PCC legislation is further evidence of the robustness of this technology, as is the acceptance by the NAIC that they should follow Bermuda's lead. The expansion of PCC provisions would not have been so widespread or so rapid unless full legal, business planning and due diligence review processes had been carried out and satisfied by each of these sponsors and domiciles. Notwithstanding this due diligence, the robustness of the PCC structure has yet to be tested in the courts.

## RENT-A-CAPTIVE VS. PCC

It is possible for cellular structures to exist without dedicated legislation to support them. One example of this is the traditional rent-a-captive cell facility, which operates on exactly the same basis as a PCC but without the statutory protections. The individual cells are segregated by contract with a shareholders' agreement being used to avoid cross-contamination. This has proved to be a successful structure for many years though it is the view of many sponsors and users that the greater safeguards available from the PCC facility, offering statutory protection, are of considerable benefit.

Nonetheless, there are traditionally-structured Rent-a-Captive providers who have elected not to adopt PCC status and who see little obvious benefit in doing so; they argue that they have been operating in this way, successfully, for some years, and have no need to change their status. The majority of these are likely to consider changing their status in the near future in order to remain competitive.

## ENTERING THE ICC AGE

In 2004 the District of Columbia amended its captive law to allow individual cells to be incorporated as legal entities in order to provide companies with added security over the true segregation of their assets from other participants within a PCC. This slightly predated Jersey's incorporated cell company (ICC) legislation and was followed suit by Guernsey in 2006.

Unlike in PCC legislation, individual incorporated cells will be allowed to transact with each other and exchange assets. The ICC law also clarifies and facilitates the conversion of cells into fully fledged captives and vice-versa and provides participants with greater flexibility in the way they operate their segregated accounts.

Compelling arguments in favour of ICC legislation have yet to be presented by regulators though and there does not seem to really be a rationale to convert existing PCCs to the ICC format. Recent changes to the Guernsey PCC legislation have reversed the previous position where creditors of a cell had automatic recourse to the core assets in the absence of a non-recourse agreement between the cell and the creditor. This has strengthened the robustness of the PCC structure. However, the ability of ICC cells to contract with each other may be a benefit for some structures where cells are owned by the same group or a joint venture is involved. In addition, the perception that the ICC structure is less open to legal challenge and inter-cellular contamination of claims, in the event of insolvency, may make the ICC more attractive for those who still harbour doubts about the PCC structure.

## CONCLUDING COMMENT

The use of cell structures will grow and prosper. They are acting as a catalyst for the fusion of capital and insurance markets, and are providing a structure and capability to move the world of risk financing into the 21<sup>st</sup> Century. PCCs and ICCs are an innovative way to help organisations to finance risk and they are flexible enough to offer a wide range of possible products and solutions. A tough insurance market will provide a further boost, as will the regulatory and fiscal attacks on conventional captives. The number of domiciles offering PCC services will expand, though the head-start gained by Guernsey, Cayman and Bermuda will see these locations consolidated as the major centres for this business.

In the near future, a further usage of the cell structure might be to enable conglomerates to restructure their entire corporate operation, taking advantage of the 'ring-fencing' and demonstrable corporate governance compliance opportunities provided by the statutory segregation of assets and liabilities. That concept would not have been credible even a year ago but now seems just one step away.

The original version of this paper, issued in September 1998, concluded as follows: "Just as Limited Liability Companies and partnerships were once a new concept, so the introduction of limited liability cells should be seen as a part of the evolutionary process of commerce". The case is proven and the contribution of cell vehicles to the transformation of the risk finance industry cannot be underestimated.

With the current state of uncertainty in the insurance market and the associated patches of volatility in terms of capacity, coverage and price, cell structures are set for a period of continued growth.

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